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SUBJECT: COLOMBIA'S COMPREHENSIVE TAX REFORM

¶1. SUMMARY: Taking advantage of President Uribe,s decisive electoral victory, the GOC presented its comprehensive tax reform bill to Congress on July 20. The revenue neutral reform includes an overall reduction in the income tax (including reduced marginal rates), offset by a significant expansion of VAT coverage. The administration proposes the gradual elimination of the tax on financial transactions and, is requesting authorization to make permanent a "war tax" on the wealthy to raise 2 trillion pesos (USD 800 million) for democratic security programs. The vote in Congress will be the first test of the strength of the Uribe Congressional coalition; given his putative allies in the Cambio Radical party have already launched a competing comprehensive proposal. End summary.

Income Tax

¶2. Uribe,s proposal would reduce the highest effective rate on income from 38.5 percent (one of the highest in the region) to 33 percent in 2008, and 32 percent in 2009. The first 34 million COP (approximately 13,000 USD) of an individual,s or company,s income (indexed to the minimum wage) would be exempt from income tax. GOC plans to tax the next 13,000 USD to 47,999 USD at 15 percent, while all income of 48,000 USD or more will be subject to the highest rate. Income tax payments would be withheld from salary payments or due on a pay-as-you-go system (similar to the United States). The overall effect of the reform would be a reduction in the income tax burden, especially for businesses that would benefit from the lower marginal rate. The new payment regime should increase compliance rates.

Business Stimulus

¶3. According to senior Finance officials, President Uribe directed the Ministry to include a package of incentives for capital investment in the tax reform proposal. The most significant of these incentives would allow businesses to shield all profits redirected toward the purchase of capital goods. Many experts have expressed concern this will place an undue burden on collection efforts, as businesses could adjust depreciation schedules on capital goods to maximize the benefits of this tax shelter, in effect reducing the overall marginal tax rate.

Expanded VAT

¶4. Currently, Colombia,s VAT applies nine different rates ranging from 0 to 16 percent on approximately 53 percent of the GDP. Uribe,s reform package would reduce the number of

VAT categories from nine to three and apply the VAT to nearly seventy percent of GDP. The general VAT, covering most goods, would increase from 16 percent to 17 percent, while a new rate of 12 percent would apply for items in the basic basket of goods. The VAT on luxury items, including cars, perfumes and cellular phones would increase from 16 to 25 percent. Education, utilities, health, and rent would remain exempt from the VAT. To meet constitutional obligations to protect the poor, the GOC plans to pay the lowest wage earners about 120 USD annually to compensate for the increase in VAT on basic necesities via Colombia,s welfare system (SISBEN).

Financial Transaction Tax

¶5. Uribe,s proposal includes a gradual phase out of the financial transaction tax. The tax has created a significant distortion of economic activity away from traditional banking, but is difficult to repeal because it is a reliable source of considerable income for the GOC. In 2004, the financial transaction tax generated 2.2 trillion COP (estimated 916 million USD), while in 2005, the collection increased 7.3 percent to 2.4 trillion (estimated 1 billion USD), representing 5 percent of total revenue generated. Resistance to the complete elimination of this tax is hardening. Recent counter proposals suggest the number of accounts taxed could be cut in half or that the tax could be reduced, but not eliminated entirely.

Dinosaur Hunting

¶6. The stamp tax, document tax, and numerous tax shelters

protecting assets in pension funds and construction savings accounts (AFCs) would be eliminated under Uribe,s proposed reform. The stamp tax and document tax, two holdovers from colonial times, no longer generate revenue and are seen by most experts as a barrier to efficiency. Pension fund - Construction Savings Accounts or AFCs, created in 1999 to stimulate the housing construction market also are eliminated. According to Vice Minister of Finance Maria Ines Agudelo, these shelters are used by the wealthiest 10 percent of Colombians and cost the GOC close to COP 70 billion (approx. USD 29 million) in lost tax revenue. Mauricio Cardenas, president of an influential economic think tank and author of part of the tax reform proposal, further explained that the exemption is a particularly important form of tax relief for those earning between USD 25,000 and 50,000 per year as the shelters effectively reduce marginal tax rate on this wage group from 38.5 percent to 30 percent.

The Permanent One-time War Tax

¶7. On July 12, the President met with 40 Congressional representatives to lay out his request for an extension of the current net worth tax intended to raise two billion COP for democratic security programs - the third iteration of the wealth tax. In 2003, President Uribe presented the wealth tax as a war tax to finance particular expenditures, much like this tax. It was then extended in 2004 to 2006 as a simple wealth tax with a much wider base and smaller rate (.3 percent on declared liquid net worth after specific deductions). In the extension of the tax, Colombians and Colombian companies with a net worth in excess of 1.5 billion COP (approximately 600,000 USD) will be taxed at a rate of .4 percent and will have two years to complete their payment to the GOC. The GOC estimates it will collect two billion pesos (800 million USD) from nearly 11,000 contributors under the proposal. The GOC surprised many experts by proposing to Congress that this tax be made annual, during the presentation of the tax reform package on July 20.

Next Step - Congress

¶8. Initial congressional reaction to the tax reform have generally been positive, but the Cambio Radical party (generally Uribe-supporting but headed by a Senator with presidential asperations for 2010) presented a competing version, indicating early in the process he will seek a compromise on key elements with the other of the "Uribe block" parties. Cambio Radical's plan is a less significant reform, but it is also revenue neutral. It proposes a slight cut in the income tax, retention of various tax shelters, and the immediate elimination of the tax on financial transactions.

Comment

¶9. Strong economic growth, a negotiated free trade agreement with the United States and Uribe's decisive electoral victory have created an environment where comprehensive tax reform is a strong possibility. It is unclear, however, how Congress will react to the Uribe proposal. On a daily basis, new press reports discuss one element or another of the reform to be scaled back or reconsidered. The elimination of the financial transaction tax and increases in coverage of the VAT have generated the most public discussion. There is much public handwringing that the increased VAT coverage will make the system more regressive. The motives of Cambio Radical in preparing a competing, less sweeping, reform are unclear, but may have much to do with the presidential ambitions of its leader, German Vargas Lleras. Colombia's professional middle class will bear a majority of the burden under the proposed reform. Facing a significant increase in VAT charges and the elimination of popular tax shelters, the potential exists for a vocal middle class push back that could affect the outcome of Uribe's reform efforts. End Comment.
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